## Interview by Vinson & Elkins with Paul Webber

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## <u>MEM</u>ORANDUM

March 8, 2004

Privileged and Confidential Attorney-Client Privileged Attorney Work Product Do Not Disclose

TO:

Paul Maco

Richard Sauer

FROM:

Benjamin S. Lippard

RE:

City of San Diego; Interview of Paul Webber

This memorandum summarizes the interview of Paul Webber. Richard Sauer and I met with Mr. Webber and Reece Bader, his colleague at Orrick, Herrington & Sutcliffe, for approximately four hours on March 5, 2004. This memorandum does not contain a verbatim or a near-verbatim transcription of this interview, but rather is a general summary of my thoughts and mental impressions regarding our discussions. Significantly, it is organized to summarize issues thematically, and does not reproduce the order in which the interview actually occurred. There was no stenographer present at this interview, and given the nature of summarizing this type of discussion after the fact, it does not attempt to describe every statement or exchange and it is possible that there are errors in this account. It also assumes familiarity with the facts of this case, and does not provide context or explanation of every factual reference. Nor does it address issues of credibility or attempt to reconcile any differences in the accounts of other individuals.

This memorandum is subject to the attorney client and the attorney work product privileges, as it was prepared in connection with our providing legal advice to the City of San Diego (the "City") in connection with a potential SEC and U.S. Attorney investigation regarding some of the matters discussed in this memorandum.

At the beginning of this interview, Mr. Sauer explained to Mr. Webber that we represented the City in connection with both an internal investigation regarding various matters related to errors in the City's financial statements and bond disclosures as well as an SEC and U.S. Attorney investigation touching on those same matters. Mr. Sauer also advised him that our conversation was not privileged. Mr. Webber was very helpful and willing to answer the questions we asked.

Discovery of 2002 footnote errors. We began by asking Mr. Webber to describe how he became aware of the situation regarding the FY 2002 financial statements and footnotes. Mr. Webber explained that he kept a "cheat sheet" containing a timeline to which he needed to refer to for particular dates, and he referred to it during the interview. Mr. Bader explained that this timeline was privileged, as it had been prepared for him.

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Mr. Webber explained that in the Spring of 2003, he had been working on a financing for the City involving the wastewater bond offering. In that financing, the credit is the Wastewater Enterprise fund, which is distinct from the City's General Fund (the general obligations of the City). He started this work in March or April of 2003. At about the same time, the City decided that it wanted to refinance the bonds associated with its Ballpark project. (The ballpark bonds are backed by the General Fund of the City.) The original bonds had been financed at a high interest rate, because when they were issued the tax-exempt status of the bonds was in question due to pending litigation. As a result, Orrick, Herrington & Sutcliffe had issued a qualified opinion. The bonds had been insured, so credit was not an issue, but there was a risk that the bonds would be taxable and thus the market insisted on a higher interest rate. This litigation had ultimately been resolved, so the City had the opportunity to refinance at a lower rate.

In June or July of 2003, Mr. Webber heard from the City that Diann Shipione, a trustee on the Pension Board, was concerned about the pension plan. The City personnel Mr. Webber spoke to characterized Ms. Shipione as a gadfly. Ms. Shipione had claimed that the City's pension plan was underfunded and that the City had not disclosed this fact. When he became aware of Ms. Shipione's concerns, Mr. Webber asked the City to provide him the amount of the UAAL. At the time, he had only seen the 2002 Valuation Report, which indicated a UAAL of about \$700 million. Mr. Webber was concerned with was how much of that amount was associated with the Wastewater enterprise fund, for purposes of his work on that offering.

The City explained to Mr. Webber that it had an agreement to pay less than the actuarially required contribution, and Mr. Webber was provided with copies of the 1996 and 2002 agreements regarding this issue. Mr. Webber's primary concern at this time was the status of the Wastewater Enterprise Fund, and he was informed by Terri Webster of the City Auditor's office that as of 2003, all pension-related shortfalls associated with the Wastewater and Water enterprise funds and resulting from payments in accordance with the 1996 and 2002 Agreements had been made good and the enterprise funds were paying at their respective actuarially required contributions ("ARC"), so there was no issue regarding underfunded pension liability. ARC is determined by the City's actuary during his annual valuation report, which sets a rate for contribution as a percentage of payroll. The City then establishes a rate for the enterprise funds using the actuary's calculations. However, for financial reporting purposes of the "actuarially required contribution" ("ARC") and the "net pension obligation" ("NPO") contained in the pension plan footnote, to establish the ARC and the NPO, the City utilized a 40-year rolling amortization period, whereas the pension plan, in calculating actuarially required contributions (based upon the actuarial report) used a 30-year fixed amortization period which began July 1, 1991. Hence the full shortfall was not recaptured. The distinction described above was not disclosed in the pension plan footnote. Consequently, when Mr. Webber assisted the City in revising the Pension Plan footnotes for the 2003 financial statements, he changed the narrative so that it was clear that the City was not utilizing the same amortization period as was the pension plan for calculating actuarially required contributions ARC and NPO for financial reporting purposes. [This came later, well after the errors were, in fact, discovered in September.] The OS for the Wastewater offering was published on August 26, 2003.

Mr. Webber also explained that the enterprise funds face a different issue than the City's General Fund in that GASB requires that the enterprise funds accrue for income statement and balance sheet purposes any underfunding of pension liability. The City's General Fund need not do so, as GASB only requires that it disclose Net Pension Obligation (NPO) in the footnotes to the financial statement and show a trending.

On September 5, Ms. Shipione sent an email to the City, the underwriters, and others addressing financial statement issues, followed up by several others. In three separate emails, Ms. Shipione made there separate allegations.

- The first allegation was that the sentence in the footnotes to the wastewater financial statements regarding the actuary's description of the "Corridor" funding method was inaccurate. At the time, Mr. Webber was working off of the 2002 financial statement, and a footnote to that statement said that the Corridor method of funding was considered by the actuary to be "excellent." Ms. Shipione alleged that the sentence was not accurate. (This issue is explained in more detail below.)
- The second issue, raised in an email dated September 8, 2003, was that there was no reflection in the financial statements of an approximately \$1.2 billion liability for post-retirement health benefits. (This issue is explained in more detail below.)
- The third allegation was that the 2002 Agreement regarding pension contributions had not been disclosed. Mr. Webber stated that he did not know about the agreement until he heard of Ms. Shipione's allegations, and the outside auditors at C&L did not know either. The 1996 Agreement had been disclosed, however. That agreement provided that if the CERS funding ratio fell below 82.3%, the City would be required to make up that shortfall. The City's position is that it would not have to cure the shortfall immediately, but rather that it would only have to begin contributing to CERS at the actuarially required rate. (This issue is explained in more detail below.)

Mr. Webber discussed these issues in a September 8, 2003 conference call with Rick Roeder, the City's actuary, and Terri Webster. According to Mr. Webber, Mr. Roeder claimed that he had never seen the pension footnote before. The City claimed that he had. The footnote language regarding the Corridor method had been taken from a 1997 or 1998 letter from Mr. Roeder. Mr. Roeder also claimed that there were other errors in the financial statements. According to Mr. Webber, per Roeder & Webster, there were a number of errors in footnote 6 of the notes to the Wastewater financial statements, in the paragraphs describing the three-year trend of NPO. Mr. Roeder had explained that there was an error because the contribution numbers included the amounts contributed for the DROP program, which should not have been included. Additionally, in paragraphs d. and e. of footnote 6 to the Wastewater financial statement, there were discrepancies between the ARC and APC (Annual Pension Cost) numbers. It appeared to Mr. Webber that the error involved picking up the wrong numbers in various financial reports. Some of these errors were also contained in Footnote 12 of the CAFR which should have been the same as footnote 6 of Wastewater but in fact did not track the same errors.

Mr. Webber stated that there was no General Fund balance sheet impact from the UAAL, but that there is for the NPO number in the statements of the enterprise funds.

In September 2003, the wastewater financing was close to closing, and Mr. Webber told the City and Mr. Roeder to review footnote 6 and find out what all of the errors were. He was not willing to allow the closing to occur until all of the errors in the footnote were known. Mr. Webber also read footnote 6 and noted a statement claiming that there was a reserve for the pension liability to the extent of the NPO. Terri Webster explained to him that this reserve was at CERS, not at the City, and that Mr. Roeder had said that there had to be a reserve in the pension plan, , but in fact there was never a "real" reserve which set aside assets of the pension plan away from basic assets used to pay pension benefits. While there was something that was denominated as a reserve, when the reserve was eliminated there was no impact whatsoever on the amount of basic assets to pay basic pension plan benefits and this is disclosed in the Voluntary Disclosures under Financial Statement Errors.

At the same time, Mr. Webber consulted with his partners regarding the issue of the financial statement errors. While the underwriters believed that the problems were not material, Orrick, Herrington & Sutcliffe did not agree. The underwriters' views were contingent on Orrick issuing an opinion, which they were unwilling to do without a full disclosure of the existing errors in the financials, at a minimum. Mr. Webber provided the City with three potential alternatives on how to proceed: (1) disclose the known errors in the financials, state that they had not been corrected, and that no review had been undertaken; (2) review the financial statements in conjunction with the outside auditors, and report on errors to the City Manager and describe them in the Wastewater disclosure document; or (3) perform a complete reaudit of the 2002 financial statements with disclosure of the discovered errors. The City initially chose the third option, on or about September 12, 2003 indicating that the City would use the successor auditing firm to the original auditor. By this time, the City had pulled the OS for the Wastewater offering.

During the late September-December 2003 time frame, the City was supposed to be reviewing its financials and reporting back to Mr. Webber. At the end of September, Ms. Webster was beginning to talk about more comprehensive due diligence review of the City's financial statements rather than a re-audit, and this was the path the City then chose. Mr. Webber did not know Ms. Shipione, but her position on the Pension Board made him take her concerns seriously. Mr. Webber obtained a copy of the 2002 Agreement and reviewed the minutes of the pension board meetings during the period when the 2002 Agreement was being considered, May 2002-November 2002. Ms. Webster was the City Auditor & Controller's proxy and delegate at the pension board meetings, and it appeared to Mr. Webber as if the City was seeking some relief from payment obligations in part out of concern over the consequences under the 1996 Agreement of the funded rates falling below 82.3% and in part because it was seeking to defer paying the actuarially required rates. Mr. Webber declined to characterize the exchanges at the Pension Board meetings off the top of his head, but suggested that the minutes of those

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meetings-would be a good source of information as would Bruce Herring These minutes are public and reflect negotiations on this issue.

During the September to December 2002 period, Mr. Webber also worked on the refinancing of the Ballpark bonds, which involved the City's General Fund, and in this effort looked at the City's pension disclosures as they related to the general fund. The City was also engaged in a review of this issue, and Mr. Webber identified Terri Webster, Mary Vittano, Lakshmi Kommi, and Rick Roeder as being involved in this effort. He obtained some projections related to the UAAL from Ms. Kommi.

Additional errors in the financial statements. The result of the September-December, 2002 period due diligence efforts by the City and its outside auditor was that additional errors were discovered in the Wastewater Fund financial statements and the CAFR. According to Mr. Webber, what began as an investigation regarding Ms. Shipione's allegations regarding pension issues ultimately revealed more errors in the financial statements, primarily in the footnotes, according to the City. For instance, the CAFR footnote discussing future liability for operating leases contained errors. This made Mr. Webber concerned regarding how such errors could make it past the outside auditors. In response to this concern, the auditors at Caporicci and Larson, the successor firm, explained to him that the 2002 audit had been done by a different firm to which the current auditing firm was the successor, and the successor had installed different procedures for reviewing financial statements. (Mr. Webber understood that the person who was the audit partner for the prior firm which, in fact, did the audit for the 2002 financial statements also is the audit partner for the City at the successor firm.) Moreover, the internal and external auditors believed that the errors that were discussed were not material. Mr. Webber stated that he did not want to debate issues of materiality with the auditors since the auditors said they were applying an auditing standard of materiality. The fact that such errors occurred was enough to disturb him about the process and he believed this information should be made available to the market. Ed Ryan, the City Auditor & Controller, who announced his retirement shortly before the Voluntary Disclosures of January 27, 2004, were released, believed that no disclosure was necessary; Mr. Ryan and Mr. Webber agreed to disagree about this issue.

There were a number of other errors in the financials. For example, the CAFR omitted certain debts related to capital appreciation bonds of the Redevelopment Agency, a \$14 million error. Mr. Webber believed that the errors made in the financials were just mental lapses or clerical errors, and that there was no pattern to the errors that suggested to him that there had been an effort to conceal anything.

In terms of correcting these errors, Mr. Webber has no personal knowledge regarding whether the City has taken the steps described in the January 2004 Voluntary Disclosures, nor did he have sufficient expertise to address the professional standards that might govern these types of issues. Given this, he had significant reservations about going forward with the same set of auditors. Mr. Webber did not state that the auditors were necessarily to be blamed for these errors – there had to be internal breakdowns in control to allow such errors to occur – but suggested that the auditors could be expected to catch such errors and the fact that they did not

has diminished his confidence in them. This was particularly due to the fact that after the Voluntary Disclosures were published on January 27, 2004, additional errors had been found in the CAFR. In February, a \$6 million understatement of assets in the Redevelopment Agency financials was found. This error may not yet have been disclosed, since the revised Wastewater OS has not been published.

Role of auditors in drafting footnotes. Mr. Webber stated that he only learned that the outside auditors had prepared the footnotes to the financial statements in the last several weeks. Mr. Webber was not surprised, however, to learn that the outside auditors had drafted the City's footnotes. He was not aware of anything that forbade this, and suggested that so long as the data, such as general ledger entries, had come from the City that there was not an independence issue.

Post-retirement health benefits. Ms. Shipione had also claimed that the City was not being forthcoming about information related to post-retirement health care benefits [Mr. Webber indicated that Terri Webster reported these benefits were not being paid by the relevant enterprise funds but rather by the General Fund to a limited degree, although primarily from the plan assets which were diverted from paying basic benefits.] A February 2003 report to the City Council had indicated that the ultimate liability associated with this issue was approximately \$1.1 billion, but Mr. Webber characterized that as a rough estimate, not an actuarial calculation. On September 26, 2003, the City ran an op-ed piece addressing the issues related to the City's ability to pay pension plan liabilities. Also in September 2003 the Mayor appointed the Pension Review Committee.

The February 2003 report had been issued by a "blue ribbon" committee investigating the issue of pension funding needs. Mr. Webber described the post retirement health care cost estimates provided by Mr. Roeder as a wild guess, not an actuarial calculation, and Mr. Webber noted that the numbers had more recently been revised downward by Mr. Roeder from approximately \$1.1 billion to \$700 million. Given this uncertainty, Mr. Webber included a range in the January 2004 Voluntary Disclosures.

On the issue of post-retirement health benefits, Mr. Webber noted that he had reviewed the report of the blue ribbon commission on that issue, and that Kathy Lexin of the City Human Resources Department had explained the benefits to him and how the payments were made. Mr. Webber did not have knowledge regarding whether or not the City is required to pay those benefits, an issue that should be looked at going forward. Mr. Webber believed that there was outside counsel looking into the issue as to whether those benefits were required for current retirees. Mr. Webber also noted that the GASB exposure draft on this issue [requiring an actuarial analysis of the exposure, similar to pension plan liability] had been withdrawn and was expected to be reissued soon. Mr. Webber thought that even if this issue was not required for disclosure in the financial statement itself, that it probably should be disclosed in the footnotes or elsewhere in a disclosure document.

Actuarial issues. Mr. Webber discussed the general role of the actuary. Both future assets and future liabilities are based on estimates and projections of the future. Mr. Webber

noted that the City's forensic accountant in a litigation matter had provided a chart breaking down the changes in the UAAL form 1996 to 2002 in an effort to determine the causes of the increase. Mr. Webber had asked for a copy of this chart, the results of which are referenced in the January 2004 Voluntary Disclosures. According to Mr. Webber, the increases in UAAL were attributable to a number of factors, including increased benefits due to the settlement of litigation as well as to market losses. According to Mr. Webber, the actuarial approach smoothes out the gains and losses in the value of Plan Assets, to mute the effect of spikes in gains or losses. The forensic actuary's chart shows investment losses beginning in 2001 and increases in UAAL. The chart does not, however, include increases in liability due to the benefit increases in 2002.

The required annual contribution towards funding UAAL depends on the amortization period used by the actuary. Currently, there is a 30-year fixed amortization period that began in 1991. To amortize, one multiplies the UAAL by the fraction 1/n where n is the number of years left in the period. Mr. Webber did not know why the 30 year period had been established in 1991. In the January 2004 Voluntary Disclosures, a footnote to the projection table regarding the amortization period described a different amortization approach, which changed to a rolling 15-year period in 2008. This amortization is not currently in use, which Mr. Webber said the footnote makes clear, but said that Mr. Roeder was planning to recommend this approach to the Plan and therefore Mr. Webber did not require another projection table using the 30-year fixed period.

The 1996 and 2002 Agreements. One of the principal issues to Mr. Webber was disclosure of the 2002 Agreement, which was not referenced in the footnotes to the 2002 financial statements, although the 1996 Agreement had been. According to Mr. Webber, the outside auditor had provided a due diligence letter stating that they had not been aware of the 2002 Agreement either. This may be due, in part, to the timing of these events. The 2002 Agreement was approved by the City Council and the Pension Plan in mid-November 2002, and the audit report was issued in late November. And the 2002 Agreement may not have been final until January 2003. Had the 2002 Agreement not been made, however, the City's required contribution would have been higher.

According to Mr. Webber, the 1996 Agreement is the subject of some dispute regarding the City's funding duty if the funded ratio fell below 82.3%. One construction of this agreement is that the City would be obliged to make good promptly any shortfall below the 82.3% level. The City's view is that falling below the 82.3% level only triggers an obligation to make payments at the actuarially required contribution level. [These alternative constructions were disclosed in the Voluntary Reports;] The City did not have the 2002 Valuation Report until January of 2003, and the meaning of the 1996 Agreement was not an issue before this because there had been no such shortfall. The 2002 Agreement clarified the City's obligations under the 1996 Agreement, but it changed this agreement as well, giving the City until 2008 to correct any shortfalls. There was no disclosure of the 2002 Agreement in the audited financial statements of the City issued for 2002. Newspaper articles began picking up the story in 2003.

Mr. Webber did not give a lot of weight to allegations that certain members of the Pension Board benefited personally from the 2002 Agreement, but stated that the potential for self-dealing raises the issue of the plan's entitlement to a tax exemption, an issue that should be investigated by fiduciary counsel. Mr. Webber stated that there was no balance sheet impact from the UAAL, but that there is for the NPO number and for the statements of the enterprise funds.

Questions raised by the SEC. Mr. Webber also addressed some of the questions that the SEC had raised:

- Have there been any actuarial calculations of the present value of post-retirement health benefit liability? No, Mr. Roeder's estimates were guesses, not actuarial calculations.
- Does the statement of the UAAL account for the lost 8% return assumed by the actuary?
  Mr. Webber suggested that Mr. Roeder should be consulted, but believed that the UAAL accounts for this factor.
- Why does the City use the 30 year amortization period? Mr. Webber did not know, but suggested Mr. Roeder would.
- Why isn't smoothing used in the 2004/2005 [not sure what calculation this refers to]?
  Mr. Webber believes that smoothing is not used in the net asset value calculation, according to Mr. Roeder.
- Why is the health care benefit paid out of the pension plan? Mr. Webber referred to page 15 of the January 2004 Voluntary Disclosures.
- Why is there no disclosure of the difference between the PUC and EAN methods of funding? Mr. Webber stated that they are both acceptable methods.
- Why are the costs of the DROP program not disclosed? According to Mr. Webber, there are no actuarial costs to this program, since pension liability does not accrue during the DROP period. The only cost is the 8% return paid by the City on DROP money, which happens whether or not the funds actually return 8% and that is disclosed in its Voluntary Reports.
- Does the funding ratio exclude some obligations or artificially reduce liability? The funding ratio projections do not include post-retirement health care benefits, employee pension contribution requirements actually made by the City, or other supplemental benefits. paid by the Plan Assets. According to Mr. Webber, these exclusions are described in the Voluntary Disclosures, following the projection table.

Market re-entry issues. Mr. Webber repeated that Orrick, Harrison & Sutcliffe was not prepared to go forward as bond counsel without either a re-audit or a cold comfort letter from a

major accounting firm. According to him, the rating agencies had reacted very strongly to the errors in the financial statements and the pension accounting issues. He mentioned Gary Kitahada, a financial advisor to the City, and Jeff Witt, who works for Mary Vattimo, as individuals that might be knowledgeable about this issue.

Additional statements. Mr. Webber made a number of other statements potentially of interest:

- Mr. Webber believes that the January 2004 Voluntary Disclosures were both timely and appropriate. Two years ago, the City was 89% funded. It issued new benefits and had bad investment results in the market, creating an issue and making the disclosure necessary. As the chart in the Voluntary Disclosures shows, by 2011, the City's required contribution will be in excess of \$300 million, which is 40% of the 2004 budget.
- Mr. Webber also observed that the bond rating agencies may not really understand municipal pension liability, and that this might, in part, explain their strong reaction to recent events.

Post Script: On Saturday, March 6, Mr. Sauer and Mr. Webber ran into each other in a shopping mall in Santa Monica, CA, and (over coffee) Mr. Webber volunteered and freely answered a number of questions regarding the errors in the City's financial statement. (Mr. Sauer paid for the coffee.) Mr. Sauer pointed out that since Mr. Bader was not present, perhaps Mr. Webber would not be comfortable discussing the matter but Mr. Webber said he would do so nonetheless.